

## **Strategic Vision for the Future of Defense and Allied Cooperation**

Presented by  
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### **Introduction**

Good morning.

It is a pleasure to be here this morning, and I would like to thank the Director of Operational Test & Evaluation, Office of the Secretary of Defense, the NDIA and the Canadian Defense Industrial Association for this invitation to provide an industrial perspective on the new global marketplace for defense.

These are certainly dramatic times for our industry, and I suggest it is worth taking a moment this morning to place the acquisition reforms we will discuss this week, in the broader context of the new landscape for defense.

### **The Shrinking Industrial Base**

The defining issue of the last decade for defense industry has been consolidation.

The reduction in the U.S. industrial base in the past 10 years has been unprecedented, and has changed in fundamental ways our industrial sector's relationship with our government customers and our shareholders.

The scope of the concurrent, and indeed worldwide, U.S. defense **procurement** decline is well known. The Year 2000 President's Budget Request represents the first real growth in defense spending sought by any Administration since 1985.

The U.S. Fiscal 2001 budget will mark the first time defense **procurement** spending has risen above 20% of a DoD budget submitted by the current Administration.

As a result of the fall in U.S. government demand, Department of Defense spending, which represented 50% of U.S. aerospace industry sales in 1989, was only 28% of industry sales last year.<sup>1</sup>

A reduced aerospace and defense industrial base had to follow the shrinking market. At their famous “Last Supper” with industry leaders, Department of Defense officials gave the signal to begin the process of shrinking the industrial base to a size sustainable at a reduced, post-Cold war, level of effort. U.S. defense industry responded with a series of mergers and acquisitions at the prime contractor level.

By 1998, six major firms accounted for two-thirds of all defense sales. From 1990 to 1998, the number of U.S. military aircraft integrators declined from eight to three, missile manufacturers from fourteen to four, space launch vehicle providers from six to 2.

The consolidation process, at least at the prime contractor level, was halted by the Pentagon in 1998 when it refused to allow Lockheed Martin and Northrop Grumman to merge on competitive grounds.

Acquisitions require a seller as well as a buyer, and as the new “mega primes” in aerospace and defense emerged in the 1990s, nearly all major U.S. commercial firms with defense operations abandoned the sector.

During the 1990s, AT&T, IBM, General Motors, Ford, Rockwell, Texas Instruments, GTE and Westinghouse all sold their defense units to focus on commercial businesses.

Whether divesting of defense operations or, like my firm GenCorp, spinning off commercial business to create a portfolio more focused on its aerospace and defense activities; we have witnessed what Loren Thompson has called “Civil Military Dis-Integration” in the industrial base.<sup>2</sup>

This process has had a significant impact on the scope of the success (or failure) of DoD initiatives to tap commercial best practices and to take advantage of commercially available technologies and processes in next generation defense systems.

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<sup>1</sup> Aerospace Industries Associate. Information provided to the AIA International Council meeting on February 1, 2000.

<sup>2</sup> Loren Thompson, The Defense Industry’s Winter of Discontent, Defense Week, January 18, 2000. Thompson is Chief Operating Officer of the Lexington Institute and a teacher in Georgetown University’s National Security Studies Program.

## The Wall Street Verdict

What is Wall Street's verdict on the state of our smaller, restructured aerospace and defense sector?

The verdict is resoundingly negative today. Across the board, defense sector stocks are at historic lows.

Even stellar earnings performers such as General Dynamics find their stock price depressed as analysts and investors abandon the sector.

Today, the combined market capitalization of the top 5 defense contractors is just over 30% of that of the merged AOL-Time Warner. Without Boeing, still primarily a civilian aircraft manufacturer, the market value of the core of the U.S. defense industrial base (Lockheed Martin, Raytheon, General Dynamics, Northrop Grumman, Litton and TRW) is just \$32.6 billion.

Walmart's capitalization is \$211 billion. Microsoft's is \$482 billion.

What is the basis of this new pessimism? This is more than a reaction to disappointing earnings of the major primes struggling to restructure operations of their enormous acquisitions.

It is, I believe, a more fundamental judgement about the inability of the government customers either to create a predictable marketplace or to allow industry the flexibility to **fully** restructure to adapt to the low level of demand.

Aerospace and defense industry remains the most regulated and legislatively dependent sector of the economy at a time when structural barriers to global civil commerce are disappearing in real time.

The annual defense budgeting cycle is a known factor in program instability and cost growth. In considering the Fiscal Year 2000 defense budget, Congress changed over half the R&D programs and almost a third of the procurement line items submitted by the Administration.<sup>3</sup>

National security or foreign policy concerns can also buffet our industry in unpredictable ways. In the year since Congress mandated the transfer of satellite export licensing from the Department of Commerce to the Department of State, U.S. suppliers are estimated to have lost 40% of the export market for spacecraft and related parts — that adds up to \$275 million.<sup>4</sup>

Our major European trading partners are increasingly blunt in their complaints about the U.S. export licensing process and its impact on transatlantic trade,

The Chairman of DaimlerChrysler Aerospace, Dr. Manfred Bischoff, wrote to Secretary of State Albright last December to inform her that his company was

Compelled to reduce its dependence on U.S. suppliers because of the burden of U.S. regulation.

The time required to secure Technical Assistance Agreements or Manufacturing License Agreements is simply not compatible with the imperative to compete in the global marketplace, especially in commercial aerospace markets. And it is these markets that are increasingly the key to our growth, and the reason we must take the warnings of our European partners, customers and competitors seriously.

But even looking at defense-unique goods and services, we can no longer afford the traditional barriers to defense trade that U.S. technology controls represent.

The U.S. Munitions List is outdated in a world in which civil technology can achieve order of magnitude performance enhancements in a matter of months.

Of course, we must protect our cutting-edge defense technologies, especially where there is a risk of diversion to third countries beyond our key Allies.

But we can no longer afford to restrict our partners access to U.S. systems for which there are alternatives on the global market, or which are imbedded in systems that have been exported previously.

Our trade policies must change, because the patterns of defense trade - especially transatlantic - are changing.

Our European allies are now launching the necessary consolidation of their defense and aerospace industries.

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<sup>3</sup> Loren Thompson, Defense Week, 1/18/00

<sup>4</sup> *White House to Mediate Agency Clash over Exports*, Defense, February 16, 2000

Powerful, politically dominant trans-European prime contractors are emerging and these firms, which include BAe Systems, the European Aeronautic Defense & Space Company (EADS), and the Thomson Group, will increasingly, through more intense competition, limit U.S. industrial access to traditional NATO markets.

Now, hopefully, these firms are effectively positioned to become partners in the next stage of industrial consolidations: transatlantic.

European aerospace industry is today the premier competitor to U.S. firms in commercial aviation, space launch services and satellite manufacture.

Last year for the first time in history, Airbus achieved more orders for new commercial aircraft than Boeing did.

The creation of EADS, BAe Systems and the growth of the Thomson Group will now accelerate the emergence of the Europeans as globally successful competitors in defense systems.

The intense pressure on the U.K. to select Matra BAe Dynamics' METEOR over Raytheon's ERAAM for future air-to-air missile capability is an example of the business and political logic underpinning European defense consolidation.

It also reflects an Allied desire to declare independence from U.S. technology controls for the export of the next generation of military fighter aircraft and their armaments.

But rather than seeing in the European industrial consolidations the advent of a new "fortress Europe", we should accept that European rationalization is the natural result of the end of the Cold War and a necessary prelude - as was the aerospace and defense consolidation in the U.S. - to new forms of transatlantic industrial cooperation.

Despite election year rhetoric in the United States, and movement towards a European Security and Defense Identity, future defense spending on **both** sides

Barely two years later, however, the lack of major defense programs to sustain even two fighter aircraft integrators (Boeing & Lockheed) in the future is forcing a review of the competitive procurement of the Joint Strike Fighter.

The process of defense industry consolidation must be allowed to continue, to reach down deeper into the supplier base, and to be international in scope if we hope to nurture an efficient and competitive industrial base for the future.

Whether or not further consolidation at the prime contractor level is allowed, there is an urgent need for rationalization of the second and third tiers of supply.

For example, in the U.S. today there are 5 major propulsion suppliers. The shrinking market, driven by capital intensive development of future commercial and military launch capability can sustain 2 or at most 3 firms. The situation in Europe is, at best, no better.

Through consolidation, the remaining suppliers will capture market share and will capture value in terms of reduced overhead costs, production efficiencies and leverage over multiple projects with prime contractors.

Consolidation at each level of the industry will have a forcing function on the next level. Prime contractors and major system and subsystem suppliers will drive down production cost by streamlining their supply chains.

Procurement remains the #1 cost driver to production. The most effective means of driving down cost while sustaining profitability is to cooperatively manage program cost with a limited set of key suppliers.

Within GenCorps' aerospace and defense unit, Aerojet, the supplier base has been reduced from 2500 to less than 500 firms today. The goal is to reduce that number to 100 key, "go to" direct supply partners.

In addition, the company invited 19 critical production partners to meet in a Supplier Board to discuss strategic planning and future needs. Two of the companies on this Board are European-owned.

A third European firm has emerged as the supplier of a critical electronic component for a major Aerojet weapon system - delivering a 30% cost reduction over the previous U.S. source.

Increasingly, I believe, success of efforts like this to put in place a global, "best of the best" supplier base will create momentum for the next step — cross border joint ventures, mergers and acquisitions.

Ultimately, given the capital market view of aerospace and defense in the U.S and the recently accelerated state of industrial consolidation in Europe, if the aerospace and defense Industry is not to lose its relevance in the new economy, it must be allowed to participate with fewer constraints in the process globalization.

Barriers to foreign ownership should fall, as they have in other industries once symbols of national pride : automotive, steel and telecommunications.

But barriers to the introduction of new technologies and the sharing of technology must also fall. For example, government customers need an aerospace and defense industry fully able to exploit new commercial technologies for electronic commerce and information management for defense.

Compare our industry to the auto industry. My company is in both. Two thirds of our offshore sales are to automotive OEMS.

That industry is in the vanguard of this new information revolution.

GM and Ford have simultaneously launched worldwide, on-line procurement systems - each expected to do \$50 billion in sales this year - their first year of on-line operations.

In that first year they intend to process nearly twice the volume of DoD's procurement - on line - and they will succeed.

My company will be present at this birth and we would welcome a similar revolution in the defense industry.

Is the gap between commercial and defense business practices widening, as has the divergence in our business cycle times?

The strategy of concurrent development, prototyping and product improvement has led to the dilution of full-scale production of military hardware, and a resulting impact on the **traditional source of bottom line profitability** – a business concept of great interest to the aforementioned analysts and investors.

Reversing the trend of civil-military industrial dis-integration by increasing procurement funding, tearing down restrictive export walls and automating processes will lead to the emergence of aerospace and defense firms that are once again attractive to investors.

## **Conclusion**

The aerospace and defense industry is facing a watershed moment in its history. The great military-industrial complex created to wage and win the Cold War has shrunk to a level that we hope is relevant to the new security environment.

The open question is whether this sector will survive as an engine of technology advancement in the new global economy.

Industry, in the interest of the shareholder, will seek to drive further consolidation and to break down barriers to an integrated Western defense industrial base.

To that end let me suggest some thoughts for you to consider this week:

Perhaps we need to go beyond bilateral agreements and MoUs and create a new forum - either at NATO or bilaterally with the European Union - to negotiate common Western policies for defense export controls and technology security?

Perhaps the Letter of intent on export controls being negotiated by the major European arms producing nations (UK, France, Germany, Italy, Spain, and Sweden) could be the basis for a transatlantic agreement?

Perhaps we could grant umbrella licenses for export of broad categories of defense goods to key partners in NATO Europe, the Pacific Rim or the Middle East - or exempt these exports from Department of State controls altogether?

Perhaps individual foreign firms could be given status equivalent to domestic suppliers and receive global licenses to receive technical data from U.S. industrial partners?

Perhaps we can expand the U.S. - Canadian agreements on an integrated defense industrial base to include other key Allies the UK, Australia, New Zealand - to reflect historic patterns of cooperation?

Perhaps the US government and the European Union competition authorities need to develop common guidelines for the review of future transatlantic aerospace and defense industry mergers and acquisitions?

**Thank you.**



